

## Internal Revenue Service

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Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B1

PLR-146992-06

Date: November 27, 2006

### Legend:

X = EIN:

State =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Tax Year 1 =

Tax Year 2 =

Member 1 =

Member 2 =

\$A =

\$B =

Dear

This letter responds to your letter dated September 22, 2006, requesting relief under section 1362(f) of the Internal Revenue Code.

Facts:

You have represented that the facts are as follows. X is a LLC formed in State on Date 1, and was taxed beginning at formation as a partnership for federal tax purposes. In Year 1, X filed Form 8832, electing to be treated as an association effective as of Date 3, which fell during Year 1. Additionally, X filed Form 2553, also effective on Date 3, electing to be taxed as an S corporation. This meant that X had two tax years for calendar Year 1. From the beginning of the year until Date 2, X was treated as a partnership for federal tax purposes – Tax Year 1. On Date 3, X's election to be taxed as an association and as an S corporation went into effect, and for the second half of Year 1 X was operating in Tax Year 2.

For all relevant dates in this ruling X had two members, who pursuant to their verbal operating agreement have agreed to share profits and losses equally and have provided for identical rights to distribution and liquidation proceeds. In Tax Year 1, Member 1 received \$A more in partnership distributions than Member 2. To make up for this imbalance, the shareholders caused X to distribute an additional \$A to Member 2 during Tax Year 2. Although this additional distribution was made during Tax Year 2, it was reported on Member 2's K-1 for Tax Year 1.

Additionally, there was an imbalance in X's capital accounts at the time of the conversion of approximately \$B. The shareholders have agreed to eliminate this disparity on X's books and will not make any distributions with respect to this amount.

Law and Analysis:

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws,

applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1362(d)(2)(A) provides that an election under section 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or (B) was terminated under section 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to section 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

#### Conclusion:

Based upon the information submitted and the representations set forth above, we conclude that X's S corporation election was effective as of Date 3, and there has been no inadvertent termination of the S corporation election due to the distribution of \$A to Member 2 in Tax Year 2. Additionally, so long as the shareholders eliminate the capital account disparity of \$B that is currently on X's books and do not make any distributions with respect to this amount, the capital account disparity will not cause an S corporation election termination.

Pursuant to the provisions of section 1362(f), X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether X's S election was valid under section 1362.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of Associate Chief Counsel  
Passthroughs & Special Industries

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes